

# Inflation Targeting Hits the Wall

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The financial-market crisis is not over but has grown into a vicious sovereign-debt crisis. Nevertheless, monetary policy makers of the major economies go on to practice the same sort of policy that has led to the crisis. Following the model of inflation targeting, they continue to disregard the quantity of money and the amount and kind of credit creation. As they did before, central bankers cut interest rates as low as they can. Few seem to remember that the monetary-policy concept of inflation targeting was adopted with the promise that low and stable inflation rates would produce financial and economic stability. Reality has not confirmed this assurance. On the contrary, inflation targeting was instrumental in bringing about the current financial crisis.

## What Is Inflation Targeting?

A central bank that pursues an inflation-targeting monetary policy model would raise the policy interest rate (which in the case of the United States is the federal-funds rate

(<http://research.stlouisfed.org/fred2/series/FEDFUNDS>) ) when the current price-inflation rate tends to move beyond the target and to reduce the policy interest rate when the rate tends to fall below the range. Operationally, the inflation rate is the target variable of this approach while the policy interest rate serves as the instrument variable. Different from monetarism, the monetary aggregates play only a secondary or no role at all in the inflation-targeting model.


The monetary policy model of inflation targeting can be expanded into the so-called Taylor rule to include the output gap and thus to encompass economic policy goals such as economic growth and employment.  (<http://www.stanford.edu/~johntayl/Finnish%20Economic%20Papers.pdf>) Unlike the original Taylor rule, monetary policy of inflation targeting in practice has ignored the growth of money and credit and uniquely selected the current official price-inflation rate as its foremost standard. Particularly in phases when the unemployment rate was found to be above the acceptable level, low rates of the consumer price index have served as a justification to bring down interest rates to excessively low levels. In many parts of the world where monetary policy employs an inflation-targeting framework, it has become a rule to ignore the expansion of monetary aggregates and to install extremely low interest rates. Inflation targeting has led monetary authorities to ignore not only money and credit growth but also asset prices along with other variables such as the exchange rate. By the rationale of inflation targeting, monetary policy has become blunt and ignorant (<http://finance.yahoo.com/news/inside-fed-2006-coming-crisis-124207691.html>) by design, and in this respect a repetition of an earlier failure has occurred just at a time when the future head of the Federal Reserve felt sure that he could promise that "we won't do it again" (<http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/default.htm>) " and let the US economy fall into depression. Not different from other areas of policies, in monetary policy, too, the only lessons that are learned from history are the wrong lessons.

As was revealed by the recent release of the transcripts

(<http://www.federalreserve.gov/monetarypolicy/fomchistorical2006.htm>) of the meetings of the Fed in 2006, central banking is a fraudulent institution where the men at the top act like deliberate ignoramuses. As the transcripts flagrantly show, it was not lack of information that made the authorities ignore reality but a deficiency of comprehension and an almost childish faith in model constructions.

## An Earlier Episode of Inflation Targeting



Inflation targeting is not new. Its basic idea was conceived by the American economist Irving Fisher (1867-1947). The Fed implemented a rudimentary form of inflation targeting shortly after it became operative in 1914 and explicitly practiced a policy of "stabilizing the price level" in the 1920s, in the decade before the inception of the Great Depression.  ([http://mises.org/journals/qjae/pdf/qjae11\\_3\\_5.pdf](http://mises.org/journals/qjae/pdf/qjae11_3_5.pdf))

The 1920s marked a period of rapid accumulation of debt that until 1929 was accompanied by a rise of wealth due to a stock-market and housing boom. The collapse of the market ushered the economy into the Great Depression, which lasted over a decade.

During the 1920s the US monetary authorities seemed little concerned with credit expansion because the main focus was the "price level" — a statistical construct that Fisher also had promoted. Noticing that the price level was "stable," the Federal Reserve felt no need to change course or to become preoccupied with what was going on. The Roaring Twenties were in fact exuberant times — albeit not for agriculture. It was industry that celebrated the new era and most of all this decade was one more heyday for Wall Street after the financial bonanza that World War I had delivered as the great enrichment of the financial sector.

The focus on price inflation had induced the monetary authorities to ignore credit growth and the expansion of money as well as to disregard the productivity gains of the US economy in this period. The Fed felt vindicated for letting the monetary aggregates expand as long as the price level remained relatively stable. No consideration was given to the notion that with productivity advances the price level should decline as had been the case when the United States was still on a full gold standard, and thus the quantity of money was relatively constant. In the 1920s, fixed on the price level, the monetary authorities did not hold the quantity of money constant, which would have meant deflation, but instead allowed an expansion of the money supply

(<http://mises.org/document/694/Americas-Great-Depression>) , because there seemed to be no reason to be concerned as long as the price level stayed stable.

What had happened in the 1920s was a wrong reaction of monetary policy makers to the widening divergence (<http://mises.org/document/691/The-Great-Depression>) between the agricultural and industrial sector of the US economy. While agriculture fell into depression already shortly after World War I, US industry experienced a monetary-induced boom. On average, the price level appeared steady, although its stability was the result of a leveling out due to the combination of a deflationary depression of the agriculture sector and an inflationary boom of the industrial sector.

## The Current Crisis


The latest episode of a megaboom occurred in the 1990s when, as in the 1920s, there was a stock-market bubble in combination with a massive increase of indebtedness of consumers for housing and other items. Central bankers did not pay much attention to the money supply and remained sanguine throughout the period that led up to the current crisis. The mantra of monetary policy was that, as long as the price level was relatively stable and only moderate price inflation rates were registered, interest rates could fall as low as they can drop, and the money supply could grow without restraint and get as large as demand of money seemed to warrant.

There were a series of severe shocks in the 1990s as well as in the decade before and after. Yet up to the outbreak of the last crisis, all of the preceding calamities could be overcome, so it seemed, with the simple tool of bailing out the creditors and by an expansion of the money supply. Inflation targeting consequently entailed a pervasive policy of bailouts and thus laid the basis of a financial culture of moral hazard (<http://mises.org/daily/1627/Mr-Bailout>) .

In 2007 financial markets suddenly began to freeze, the flow of money in the interbank market came to a sudden standstill. It was as if a cardiac infarction had hit the heart of the financial markets. Albeit shocked, monetary policy makers demonstrated full confidence that a proper amount of liquidity injection would make the markets move again and soon; thus, they believed in their naïve conviction, the economy would recover to full bloom again. Yet doom set in when the old recipe didn't work anymore. Despite massive injections of liquidity, markets only slightly recovered, and in 2008 a wave of defaults of financial institutions occurred. In August 2011, the United States came close to bankruptcy when Congress was reluctant to raise the statutory debt limit. Shortly thereafter

the global financial crisis deteriorated into the European sovereign-debt crisis

(<http://www.financialsense.com/contributors/antony-mueller/2011/12/30/whats-behind-the-euro-crisis-and-how-will-it-end>) . Greece came close to bankruptcy and contagion hit Spain, Portugal, and Italy.

By early 2012, monetary policy has reached a stage where it is almost completely paralyzed. With interest rates close to zero in the major economies of the world, it is only through gargantuan amounts of liquidity injections that the financial system is propped up. By practicing a "zero interest rate policy" (ZIRP), by buying assets of dubious quality from financial institutions through its Troubled Assets Relief Program (TARP) and by trying to pump ever more liquidity into the market through its policy of "quantitative easing" (QE), an expansion of unprecedented proportions of the Federal Reserve's balance sheet has occurred.  (<http://www.federalreserve.gov/releases/h41/hist/h41hist2.pdf>) The real or imagined assumption that the financial system is on the verge of complete collapse has brought about massive government bailouts and stimulus programs that have resulted in rising fiscal deficits and unsustainable public-debt burdens. Deflation has become the ultimate scare of governments and the dreadful nightmare of central bankers.

## Fear of Deflation

It is largely forgotten that the spectacular economic rise of Britain, of parts of the European continent, and of the United States in the period of almost a century until the outbreak of World War I was characterized by moderate deflation, particularly since the beginning of the latter half of the 19th century when productivity increases began to accelerate. The price level did fall in the expanding economy because the money supply was linked to the gold stock and the gold stock was relatively constant. The deflationary period was marked by the ascendancy of prosperity brought about by a financial environment of stable interest rates, moderate long-term declining prices, and rising real wages. Letting good deflation happen put a break on excessive economic growth. A fixed stock of base money prevented the excess on the upside, and thus it automatically provided a safeguard against the excess on the downside. A stable stock of base money did not imply a strictly fixed amount of liquidity, because an adaptable velocity of money does provide a range of flexibility.

The outbreak of World War I marks the end of the deflationary period and the beginning of the inflationary age. When the last obstacle against a full discretionary hold on money was instituted and the Federal Reserve gained unrestricted power to produce as much money as it wanted, a new chapter in monetary history began. With the abandonment of the last remnants of the gold standard with the Smithsonian Agreement (<http://www.investopedia.com/terms/s/smithsonian-agreement.asp#axzz1idM1Ccvl>) , monetary policy no longer had any anchor other than some kind of a policy concept. By slashing what was left of a monetary anchor in 1971, the monetary base (<http://research.stlouisfed.org/fred2/series/BOGAMBNS?cid=124>) of the US dollar began to rise and has swelled into an avalanche of money (<http://research.stlouisfed.org/fred2/series/MZMSL?cid=30>) .

Now, the escalation of government debt to exorbitant heights practically prohibits central banks from raising interest rates if inflation should emerge more prominently. As of now, the additional liquidity that the major central banks have created serves mainly for the banking sector to refinance itself. Monetary policy has become a vehicle for the bailout of a whole sector of the economy. By coming to the rescue of the financial sector, central banks have delivered even more monetary dynamite. The world is at a crossroads. The chance to get out of the fix without great pain is much smaller than of having either a hyperinflation to be followed by economic depression or of crashing right away into the abyss of a deflationary depression. Monetary policy has reached the dead end. Once again a magic formula of an interventionist monetary policy has hit the wall.

## Conclusion

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Inasmuch as central banks dominate the discourse about monetary policy, there is almost no debate going on about the thesis that inflation targeting is not only defective in guaranteeing monetary stability but that it also provided the conditions for the current financial crisis to happen. The episode that was praised as the great moderation was a great delusion, which has become the nightmare of a long stagnation. There is a vital need to establish a sound monetary system. Its consequence would be moderate deflation and the avoidance of extreme booms and busts. The main

barrier against sound money is neither intellectual nor practical but political. The resistance comes from the public sector because the chief casualty of an institutional change to sound money would be the modern inflated government along with its warmongers, debt pushers, and all the rest of the spin doctors of deceitful promises who form part of this kingdom.

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